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AGENDA ITEM 4b

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Enhanced Equity Portfolio – Internally Managed

II. PROGRAM: Total Fund

III. RECOMMENDATION: Information Only

IV. ANALYSIS:

Background

In June of 2007, Bear Stearns announced that there were troubles with meeting margin calls in two mortgage and asset-backed fixed income hedge funds; this announcement touched off what has since become known as the "subprime crisis" in the global fixed income markets. The foundations for this crisis were laid over years of very inexpensive credit and rising housing prices, causing lenders to increasingly lend assets to entities with lower credit quality. These loans carried with them longer durations and were financed through borrowing in the short-term / overnight markets. As a result of the crisis, liquidity in the short-term funding market has been greatly reduced, causing even high credit, well-performing assets to trade at a steep discount to expected fair value.

The discounts currently available in the short-term fixed income market have created an opportunity to garner returns in excess of LIBOR (the London Inter-Bank Offer Rate, effectively a global version of the United States' Fed Funds rate). The opportunity to earn a return on high quality fixed income assets in excess of LIBOR creates the possibility of staff managing an enhanced equity portfolio. An enhanced equity return is possible due to the pricing mechanisms that exist in the equity derivatives market. Equity derivatives are typically traded and priced based on interest rates that approximate LIBOR. If we are able to earn a rate of return in excess of LIBOR on the cash underlying an equity derivative position, the excess return translates into value added on the equity derivative position.

The combination of an equity derivative position coupled with a cash investment in LIBOR type investments, has equity market volatility and is considered to be “equity” from an asset allocation perspective. An opinion letter from Wilshire is included as Attachment 1.

Proposed Portfolio

The origin of the concept to create this opportunistic portfolio lies in the CalPERS Global Fixed Income team, which has identified the potential for value added due to mispricing of high quality asset-backed debt instruments. The magnitude of the opportunity is reflected in the current pricing structure of various types of asset-backed paper. For example, investment grade paper backed by student loans is trading at a positive spread to LIBOR of 70 basis points. The historic spread on this paper has been a discount of 2 basis points. The current market level represents more than 42 standard deviation units above the typical level. See chart in attachment 2.

It is believed that the opportunity will only be present for a limited period of time and the resulting portfolio has an expected life of three years or less, before the expected returns are realized.

Given this perceived availability of fixed income alpha, coupled with an ongoing need to deploy capital in the public equity markets, CalPERS Fixed Income and Global Equity have designed an enhanced equity index portfolio expected to deliver equity returns plus the fixed income alpha. In the current market environment, it is anticipated that the strategy would earn the domestic equity benchmark return (Wilshire 2500) plus approximately 50 basis points of excess return.

The design for the portfolio is fairly simple, consisting of two main parts:

1. A fixed income portfolio made up of short-term, high quality, asset backed securities. The expectation for this portion of the portfolio is that it would earn LIBOR plus 50 basis points.

2. A futures overlay designed to replicate the performance of the Wilshire 2500 index.

The fixed income portion of the portfolio would be managed by CalPERS Global Fixed Income in a manner nearly identical to that of the current High Quality

LIBOR (HQL) portfolio and would abide by the HQL policy. The portfolio of futures would be managed by CalPERS Global Equity in a manner similar to numerous other futures portfolios currently managed by the group (e.g. the cash equitization program). This portion of the management would be done with existing vendors and systems including trading, operations, and the posting of margin. This portion of the strategy would fall under CalPERS' derivatives policy, avoiding leverage and using futures purely to generate an equity-like return.

Benefits and Risks

There are several benefits to the strategy including:

- Enhancing Investment performance: expected to earn the return on CalPERS' domestic equity benchmark of the Wilshire 2500 plus a targeted 50 basis points of excess return.

- Capturing of synergies between CalPERS Global Fixed Income and Global Equity: as the two teams work together to exploit both this and potential future opportunities.

- Garnering of further knowledge and experience in this area: laying the foundation for potential future strategies and potentially more informed oversight of external managers.

There are also a handful of risks to the strategy that should be taken into consideration. These include:

- While the fixed income portion of the portfolio will be made up entirely of short-term, high quality issues, there will be some duration and credit risk associated with the portfolio. This would likely only come into play in a forced liquidation of the portfolio.

- The basket of futures used in deploying the strategy will not perfectly replicate CalPERS' Custom Wilshire 2500 benchmark. While the predicted tracking error of the futures basket is very tight and, over time, is expected to average out to zero over time (equal likelihood of outperformance as underperformance), there could be periods in which the futures basket underperforms the equity benchmark.

- The cost / risk around the rolling of futures contracts, while currently anticipated to actually add a slight amount of performance to the strategy, this could change and could potentially result in a cost (and thereby reduced performance).

<u>Conclusion</u>

CalPERS staff, from both Global Fixed Income and Global Equity, believe that there is a legitimate opportunity available in the market currently to manage a portfolio of high quality, short-term fixed income assets overlaid with futures that will deliver equity-like returns plus approximately 50 basis points of excess return. While this opportunity will likely not be available forever, it is available due to the current crisis in short-term fixed income markets, resulting in high quality asset-backed securities trading at a discount to fair value. Staff requests Investment Committee feedback on funding a strategy to exploit the opportunity currently available. Pending positive feedback, staff plans to return with an action item at the September Investment Committee meeting.

V. STRATEGIC PLAN:

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.

- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The primary benefit of the strategy would be the excess returns generated in the portfolio, with the additional benefits of finding synergies across asset classes within CalPERS and furthering staff knowledge. The strategy could be managed entirely with existing staff and technology resources resulting in no fixed costs and only minor marginal costs in terms of use of staff time.

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